CHAPTER V
TRADE CREDIT AND PROVISIONS

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(A) Nature of Trade Credit and Provisions

(B) Trade Credit and Provisions and Financing of Cotton Textile Mills of Ahmedabad.

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(A) Nature of Trade Credit and Provisions

The term 'Trade Credit & Provisions', as defined earlier, is applied to that part of non-proprietorship funds which is not derived from either 'Secured loans' or 'Unsecured loans'. It includes all current liabilities and provisions. Bills payable, sundry creditors, advance payments received, unclaimed dividends, etc., are included in the current liabilities. The term 'Provisions' includes provisions for taxation, proposed dividends, provisions for provident fund, insurance, and pension & staff benefit schemes. Because of its major contribution, the provision for depreciation is studied separately at a later stage.

Trade credit arises when a business or industrial unit receives goods from a supplier without the requirement of immediate cash payment. It is normally described by three elements:

(i) The amount of cash discount from the invoice price,
(ii) The time interval within which the discount applies, and,
(iii) The time when the gross amount of invoice must be paid.

Trade credit generally stands next only to bank credit as a source of short term finance to business. It is the chief stand-by for small and medium sized firms for three reasons:
(i) It is automatic. A seller usually grants it because his competitors do.

(ii) It is convenient. A firm or a company need not go through the time consuming and perhaps embarrassing procedure of applying for a loan. The firm can simply defer paying cost for its purchases.

(iii) It appears to be inexpensive. To many users, it has no apparent cost. The only cost may seem to be the price of the goods purchased. However, the firm granting trade credit incurs cost by tying up its money in an account receivable and it must cover its cost to stay in business.

A business that pays cash for its purchases without demanding a discount may be paying for something it is not receiving. The cost of trade credit is usually concealed in the supplier's price. The following is the simple formula used to estimate the cost of trade credit:

\[
\frac{\% \text{age discount}}{\text{period used}} = \frac{\text{Annualised rate}}{360}
\]

Suppose the rate of discount is 2% p.a. and the discount is taken benefit of for 30 days. Then, the cost of trade credit \(x\) will be as follows:

\[
\frac{0.02}{30} = \frac{x}{360}
\]

\[
0.02 \times 30 \times x = 7.20
\]

\[
x = 0.24
\]
Traditionally trade credit has been used by large firms to finance inventories and to some degree, receivables. They have been able to borrow long term funds and in effect, relend them to their customers through liberal credit terms. Terms on which trade credit is granted are determined by the interplay of several factors:

(i) **Competition**: A new firm entering an industry will be forced to grant terms at least equal to those granted by its competitors. To do otherwise would limit the firm's sales.

(ii) **Nature of product**: It affects trade credit. Products with high turnover are sold on short credit terms; e.g., Dairy industry has shorter credit than the steel industry.

(iii) **Financial position**: A financially strong buyer will ordinarily receive liberal terms because the seller need not fear a default. If the buyer is financially weak, the seller runs a greater risk of default and will probably restrict both the amount and the terms of whatever credit he extends.

Widespread reliance on trade credit despite its high cost, reflects the conflict between cost and availability of finance. Companies use it because it is available; a factor often completely dominating cost. If businesses are not in a position to obtain finance elsewhere, they rely on suppliers to finance them. For many struggling firms trade credit is the only source of external finance available and must be relied upon regardless of cost.
There are three types of trade credit:

(i) Credit on open account, (ii) Notes payable, and, (iii) Trade Acceptances or Bills Payable.

(i) **Credit on open account** is the most common arrangement. With this, the seller dispatches goods to the buyer along with an invoice that specifies the goods shipped, the price, the total amount due and the terms of sale. Open account credit derives its name from the fact that the buyer does not sign a formal debt instrument evidencing the amount that he owes to the seller. The seller extends credit on his credit investigation of the buyer.

(ii) **Promissory Notes or Notes Payable** are employed in some situations instead of open account credit. In this case, the buyer is asked to sign a note that evidences the debt to the seller. The note itself calls for the payment of the obligation at some specified future date. This arrangement is employed where the seller wants the buyer to recognise his debt formally. He may request a promissory note from the buyer, if the later's open account becomes due.

(iii) **Trade Acceptances or Bills Payable** is another arrangement by which the indebtedness of the buyer is recognized formally. Under this arrangement, the seller draws a draft or a bills of exchange at some date in future. The seller will not release the goods until the buyer accepts the bill of exchange. When the buyer accepts a draft, he designates a bank at which draft will be paid.
when it becomes due. At that time, the draft becomes trade
acceptance and depending upon the creditworthiness of the
buyer, it may possess some degree of marketability. If
so, the seller can get it discounted and receive immediate
payment for the goods. At final maturity, the holder of
the trade acceptance presents it to the designated bank
for collection or the buyer himself arranges for the
payment.

Trade credit is a source of finance, because the
buyer does not have to pay for goods until they are deli-
vered. If the firm automatically pays its bills a certain
number of days after the date of invoice, trade credit
becomes a built-in source of finance that varies with
the production cycle. As the firm increases its produc-
tion and the corresponding purchases, accounts payable
increase and provide a part of the funds needed to finance
increase in production. As the production decreases,
accounts payable tend to decrease. Although the variat-
ions in the accounts payable may not be directly propor-
tional on account of shortages of inventory on hand,
there is a strong degree of correspondence. If the firm
adheres strictly to the practice of paying bills at a
given time after invoice, trade credit is not a discretion-
ary source of finance. It is entirely dependent upon
the purchasing plans of the firm, which in turn, are
dependent upon its production cycle.
The firm must balance the advantages of trade credit as a discretionary source of financing without any explicit cost against the cost of foregoing a cash discount and the opportunity cost associated with the deterioration in trade credit as a form of short term financing. If the firm is now taking advantage of cash discount, additional credit is readily available by not paying existing accounts payable until the end of the agreed period. There is no need to negotiate with the suppliers. The decision is entirely up to the firm. Trade credit is a flexible means of finance. The firm does not have to sign a note or pledge or collateral or adhere to a strict payment schedule on the note. A supplier views an occasional delinquent payment with a far less critical eye than a banker or other tenders.

Typically, a higher percentage of the total liabilities of a small firm is comprised of trade credit than is true of a large firm. In periods of tight money, it has been contended that large firms obtain credit more easily than small firms do. However, small firms still have access to trade credit as a means of finance. Often, this credit comes from large suppliers, who in turn, avails themselves of other sources of finance.

The advantages of using trade credit must be weighed against the cost. The cost may be very high when all factors are considered. Many firms utilise other sources of short term finance to take the benefit of cash discount.
However, the savings in cost over other forms of short term finance must offset the flexibility and convenience of trade credit. For certain firms, moreover, there simply are no alternative sources of short term credit.

It is, although, true from managerial analysis point of view that there is no explicit cost of trade credit. It overlooks the fact that somebody must bear the cost of trade credit for the use of funds over time it is not free. The burden may fall on the supplier, the buyer or both. In the case of a product with elastic demand, the supplier may be reluctant to increase the prices and may end up in absorbing most of the cost of trade credit. Under other circumstances, the supplier is able to pass the cost on to the buyer.

Provisions for tax and Provision for depreciation are the important constituents of short-term funds. The deferred payment of taxes can be a source of temporary working capital. Taxes not paid from day-to-day but the accrued liability thereof are indicated by provision for tax. The period of time during which a business holds and may use these funds ranges from a minimum of a month in the case of withheld income tax and excise duties to a minimum of three months in the case of some state and local sales taxes. If earnings of a company are fairly uniform throughout a year, it has the use of funds required to pay taxes for about 10 months. If earnings remain uniform from year to year, the tax-provision would become, in effect, a permanent source of working capital.
The study of Table V and Table XIX indicated that the share of trade credit & provisions in total funds had increased by about 22.70%, from 24.60% during 1966-70 to 30.20% during 1971-75. This means that trade credit and provisions, particularly the provisions had contributed a larger share during the latter period. This increase was accompanied by a decline in the variability factor from 33.48% during 1966-70 to 25.15% during 1971-75. This means that the cotton textile mills of Ahmedabad had adopted fairly similar policies in relation to the use of this source of finance during both the periods, and the degree of uniformity had increased during the latter period. This also means that a larger number of companies were following uniform financial policies during the latter period as compared to the former.

Exceptionally, the share was above the overall average during both the periods in the case of unit Nos. 23, 33, and 45, and it had increased further during the latter period. As against this, in the case of unit Nos. 1, 3, 5, 6, 7, 12, 15, and 28, the share was below the overall average during both the periods. In the case of unit Nos. 5, 6, and 12, the share had declined further and in other cases, it had increased during the latter period.
A reference to Table VI and Table XIX showed that the share of trade credit & provisions in non-proprietorship funds had increased by about 20.45%, from 35.20% during 1966-70 to 42.40% during 1971-75. This increase was accompanied by a notable change in the variability factor from 27.53% during 1966-70 to 20.99% during 1971-75. This means that the financial policies in this regard adopted by the cotton textile mills of Ahmedabad were fairly uniform during both the periods and the degree of uniformity had increased further during the latter period.

Exceptionally, the share of the unit Nos. 2, 8, 13, and 49, was above the overall average during both the periods. In the case of unit No. 8, the share had declined, whereas in the case of the other units, it had increased further during the latter period. As against this, the share was below the over-all average during both the periods in the case of unit Nos. 1, 3, 6, 7, 28, 31, and 42. In the case of unit No. 6, it had declined further, whereas the share of other units had increased during the latter period.

The extreme cases of unit Nos. 6, 33, and 45, are worth noting. In the case of unit No. 6, the share of trade credit & provisions in total funds was 17.13% during the former period and it had declined to 15.77% during the latter. This position can be explained in terms of the following factors:

(i) The proportion between proprietorship funds and non-proprietorship funds had remained almost
constant, i.e., 30:70 during both the periods. The share of reserves in total funds had increased during the latter period. The unit had never distributed more than 45% of PAT by way of dividend.

(ii) It had collected more funds by way of secured loans as well as unsecured and short term loans from banks and other financial institutions during the latter period.

(iii) This was one of the few units in Ahmedabad which had increased the share of debenture finance in total funds during the latter period.

(iv) It seemed that it had not followed a policy of keeping large amounts left unpaid in terms of trade credit. It seemed to have succeeded in relying less on public deposits and in fact repaid a part of the deposits because of its comfortable liquidity position.

In the case of unit No. 33, the share of trade credit & provisions in total funds was fairly higher than the overall average for all the textile mills of Ahmedabad. The share had increased further from 41.03% during 1966-70 to 43.19% during 1971-75. This position seemed to be on account of the following factors:

(i) Its earning capacity had declined during the latter period. In fact, it had large accumulated losses during the latter period. Its dividend payment
record also was poor. It had failed to keep up the confidence of the shareholders.

(ii) It seemed that it had to rely more on non-proprietorship funds. In fact, the share of non-proprietorship funds had increased from 86.20% during 1966-70 to 89.96% during 1971-75.

(iii) The absence of good profitability record and ploughing back capacity seemed to have resulted in more reliance on some of the components of non-proprietorship funds. The share of bank secured loans, however, had declined from 36.13% to 24.70% during the latter period and therefore it had relied more on loans from specialised financial institutions to the extent of 17.24% of total funds during the latter period as against 6.39% during the former period.

(iv) Because of the poor liquidity position, it seemed that large amounts of tax, trade credit, etc., were left unpaid.

(v) The public, in general, did not have confidence in the management of this unit and therefore, the share of public deposits in total funds had declined from 0.36% to 0.11% during the latter period.

Thus, it had to rely on trade credit to a larger extent during both the periods.
In the case of unit No. 45, the share of trade credit & provisions in total funds was not only above the overall average during both the periods, but had increased further from 37.11% during 1966-70 to 43.76% during 1971-75. This means that a large part of funds had been collected through trade credit and provisions. In fact, this unit had relied on non-proprietorship funds on a large scale. It had collected nearly 80% of total funds through non-proprietorship sources during both the periods. The following factors seemed to explain this situation:

(i) It seemed that as a part of the overall policy to rely on external sources, the management had opted for trade credit as a source of finance. This source of finance being relatively simple and easy to obtain, had been taken advantage of increasingly during the latter period.

(ii) The share of secured loans from banks had declined from 31.48% during 1966-70 to 22.95% during 1971-75. Even the short term and unsecured loans from banks and financial institutions had declined from 5.49% during 1966-70 to just 0.21% during 1971-75.

(iii) As regards the profitability position, it was never satisfactory. The share of reserves had declined from 9.48% during 1966-70 to 8.86% during 1971-75.

(iv) It had not collected any amount through public deposits and had not taken the benefit of the DPG Scheme.
Thus, it seemed to have no other alternative but to rely on trade credit & provisions.

The Table V.1 presents in a comparative form the role of trade credit & provisions as a source of finance as studied by different authors.

Table V.1

<table>
<thead>
<tr>
<th>Study (1)*</th>
<th>Study (2)*</th>
<th>Study (3)*</th>
<th>Study (4)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Trade credit &amp; provisions as a %age of total funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) 1966-70</td>
<td>24.60</td>
<td>56.50</td>
<td>50.40</td>
</tr>
<tr>
<td>(ii) 1971-75</td>
<td>30.20</td>
<td>56.50</td>
<td>62.60</td>
</tr>
<tr>
<td>(b) Trade credit &amp; provisions as a %age of non-proprietorship funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) 1966-70</td>
<td>35.20</td>
<td>N. A.</td>
<td>58.30</td>
</tr>
<tr>
<td>(ii) 1971-75</td>
<td>42.40</td>
<td>N. A.</td>
<td>75.32</td>
</tr>
</tbody>
</table>

The above data suggest:

(i) That the share of trade credit & provisions in total funds had generally shown a rising tendency in the case of cotton textile mills of Ahmedabad, as well as All-India All-Industries.

* (1) The present study of financing of cotton textile mills of Ahmedabad.
(ii) Whereas the share in total funds in the case of the entire cotton textile industry had remained constant throughout 1966-75, the share in the cotton mills of Ahmedabad had increased by 23%.

(iii) The share in total funds in the case of All-India All-Industries had increased by 37% as per study No. 4. The growth was faster than that in the case of cotton textile mills of Ahmedabad.

(iv) In the case of large public limited companies, the share had increased by 24%, which was almost similar to that in the 50 cotton textile mills of Ahmedabad.

(v) In the case of cotton textile mills of Ahmedabad, the share of trade credit & provisions in non-proprietorship funds was lower than that in the case of large public limited companies as per study no. 3. In addition to this, the increase in this share was fairly higher, i.e., 29%, than that in the case of cotton textile mills of Ahmedabad, being about 20%.

It may be concluded that the cotton textile mills of Ahmedabad had relied on trade credit and provisions to a less extent than either the cotton textile industry in general or the All-India All-Industries. This was despite the fact that 'Trade Credit & Provisions' was a major source of non-proprietorship funds for the cotton textile mills of Ahmedabad during both the periods of the present study.